

TITLE 10. CALIFORNIA DEPARTMENT OF CORPORATIONS

NOTICE IS HEREBY GIVEN

The California Corporations Commissioner ("Commissioner") proposes to amend Sections 1710, 1717.2, 1726, 1730, 1732.2, 1737, 1737.1 (renumbered as 1737.3), 1738, 1738.2, 1738.3, 1738.5, 1740.1, 1740.4, 1741.1 and 1741.3 and adopt Sections 1709.1, 1717.2, 1730.1, 1737.1, 1737.2 and 1738.6, under Title 10 of the California Code of Regulations, promulgated under the Escrow Law, relating primarily to escrow transactions over the Internet by Internet escrow agents.

PUBLIC HEARING

No public hearing is scheduled. Any interested person or his or her duly authorized representative may request, in writing, a public hearing pursuant to Section 11346.8(a) of the Government Code. The request for hearing must be received by the Department of Corporations' ("Department") contact person designated below no later than 15 days prior to the close of the written comment period.

WRITTEN COMMENT PERIOD

Any interested person, or his or her authorized representative, may submit written comments relevant to the proposed regulatory action to the Department, addressed to Kathy Womack, Office of Law and Legislation, Department of Corporations, 1515 K Street, Suite 200, Sacramento, CA 95814-4052, no later than 5:00 p.m., July 29, 2002. Written comments may also be sent to Kathy Womack (1) via electronic mail at regulations@corp.ca.gov or (2) via fax (916) 322-5875.

INFORMATIVE DIGEST/POLICY STATEMENT OVERVIEW

Over the last couple of years, the California Legislature enacted several bills that amended the Escrow Law (Financial Code Section 17000, et. seq.) to recognize and accommodate the new business of performing escrow transactions over the Internet by companies now labeled as Internet escrow agents. The bills are Assembly Bill 583 (Chapter 441, Statutes of 1999), Assembly Bill 410 (Chapter 253, Statutes of 1999), and Assembly Bill 333 (Chapter 437, Statutes of 2000).

AB 583 amended the Escrow Law to recognize and encompass the performance of escrow agent services over the Internet, including the recognition of, and the addition of a definition for, "Internet escrow agent," the recognition of electronic communications, and the transmission of escrow instructions electronically.

AB 410 amended the Escrow Law to limit the membership requirement for escrow agents with, and indemnity coverage by, Escrow Agents' Fidelity Corporation ("EAFC") to those licensees engaged in the business of receiving escrows in certain listed types of transactions. The bill limits EAFC's coverage to loss of trust obligations with respect to those listed types of transactions and requires escrow agents to obtain separate fidelity bond coverage for all other types of transactions, such as personal property transactions performed by Internet escrow agents. The bill also requires

members of EAFC who engage in both listed and non-listed types of transactions to maintain separate books and records of account and separate trust accounts.

AB 333 amended the Escrow Law to expand the definition of escrow transactions conducted by Internet escrow agents to include those taking place on the Internet for the sale or transfer of personal property or other services. AB 333 permits Internet escrow agents to use Internet-authorized payment alternatives and substitutes electronic transfers (such as wire transfers) for traditional account transfers. The bill also allows Internet escrow agents to maintain all records required under the Escrow Law electronically and to provide those records to the Commissioner in electronic format. Furthermore, the bill allows an Internet escrow agent to establish a customer contact center that is not required to be licensed as a branch office nor staffed by a qualified person provided the location is used solely for the purpose of responding to customer electronic messages and telephone inquiries. Finally, the bill requires that a person possessing knowledge and understanding of the Escrow Law, regulations and accounting shall be on duty at each business location of an Internet escrow agent during business hours.

In general, the Commissioner proposes to make the following changes to the Escrow Law regulations in order to: (1) conform the rules to the changes made in the law as a result of the enactment of AB 583, AB 410 and AB 333; (2) eliminate any inconsistencies between the law and the regulations resulting from the enactment of these bills; and (3) continue to ensure that adequate protection is provided to the public that uses the services of escrow agents, including Internet escrow agents.

Section 1709.1: Financial Code Section 17005.3 (second of two) provides a definition for “customer contact center,” which allows an Internet escrow agent to establish a customer contact center that is not required to be licensed as a branch office pursuant to Financial Code Section 17213.5, if it is used solely for the purpose of responding to customer electronic messages and telephone inquiries. The Commissioner proposes to adopt Section 1709.1 to require Internet escrow agents to notify the Commissioner of the business location of customer contact centers at least 10 days prior to commencing business activity, and to notify the Commissioner at least 10 days prior to the change in address of a customer contact center.

Section 1710: Section 1710 provides that all of the Escrow Law regulations are applicable to joint control agents as described in Financial Code Section 17005.1 and that all references in the regulations to “escrow agent” shall be deemed to refer to joint control agents. The Commissioner proposes to amend this section to provide that the Escrow Law regulations are also applicable to Internet escrow agents as described in Financial Code Section 17004.5 and that the references in the regulations to “escrow agents” shall also be deemed to refer to Internet escrow agents.

Section 1717.2: Financial Code Section 17200.8(b) requires that within the organization of each Internet escrow agent corporation engaged in the business of escrows involving personal property, one or more qualified persons shall demonstrate knowledge and understanding of the Escrow Law (as set forth in Division 6 (commencing with Section 17000)), the rules promulgated thereunder and accounting practices and procedures. The Commissioner proposes to adopt Section 1717.2 to clarify the experience requirement for Internet escrow agents in order to comply with Financial Code Section 17200.8(b). New Section 1717.2 would set forth the requirements that a person would need to meet in order to be a “qualified person” for purposes of Financial Code Section 17200.8(b), as follows:

- (a) Execute an affidavit certifying under penalty of perjury that the person has read and understood the provisions of the Escrow Law and the regulations promulgated under the Escrow Law; and
- (b) Possess a minimum of two years of experience performing and/or supervising accounting functions that are similar to those functions that will be necessary to maintain the books, records and accounts of the Internet escrow agent as required by the Escrow Law and its rules; or
- (c) Successful completion of beginning and intermediate accounting courses or equivalent accounting courses with a grade of “C” or better from an accredited college. College transcripts shall be provided to the Commissioner to demonstrate this requirement has been met.

Section 1726: Section 1726 requires EAFC to notify the Commissioner that an escrow agent has paid the required membership fees. This section also requires the escrow agent to notify the Commissioner, on the form prescribed, of the names of any officer, director, trustee, employee, or other person directly or indirectly compensated by the escrow agent and to file fingerprint cards for those individuals that are not already on file with the Commissioner. The Commissioner proposes to amend this section to require EAFC to notify the Commissioner that the membership fees have been paid only for those escrow agents that are required to be members of EAFC as provided for in Financial Code Section 17312(a) and (c). The Commissioner also proposes to amend this section to allow an escrow agent to file with the Commissioner a “Request for Live Scan Service,” instead of a fingerprint card, which allows applicants to submit fingerprints electronically using live scan technology.

Section 1730: Section 1730 currently requires that the escrow agent maintain its books, records and accounts in the State of California and requires that the escrow agent notify the Commissioner in writing of the location of the books and records. This section also requires that the escrow agent notify the Commissioner 15 days prior to changing the location of such books. The Commissioner proposes to amend Section 1730 to require that the escrow agents who are engaged in the business of receiving escrows specified in Financial Code Section 17312(c) and are required to be members of EAFC shall have their business offices located in California and maintain their books, records and accounts

in the State of California. Those escrow agents that are not engaged in the business of receiving escrows specified in Financial Code Section 17312(c) and are not required to be members of EAFC (e.g., Internet escrow agents) shall be allowed to maintain their books, records and accounts in the State of California or in the state they are located in.

Section 1730.1: Financial Code Section 17405 requires the Commissioner to conduct a routine regulatory examination of every escrow agent at least once every four years and authorizes the Commissioner to conduct other nonroutine inspections and examinations at any time. Financial Code Section 17405.1 requires that the escrow agent shall pay for the cost of every inspection and examination. Financial Code Section 17209 provides that the application for an escrow agent's license may include other items required by the Commissioner. The Commissioner proposes to adopt Section 1730.1 to provide that a license for a business located outside this state may be issued only to those escrow agents that are not engaged in the business of receiving escrows specified in Financial Code Section 17312(c) and are not required to be members of EAFC if the escrow agent agrees in writing in the license application to pay the reasonable expenses for travel, meals and lodging of the Commissioner or the Commissioner's representatives incurred during any investigation or examination made at the escrow agent's location outside this state.

Section 1732.2: Section 1732.2 currently requires that an escrow agent shall maintain certain books and records. Financial Code Section 17409 requires that those escrow agents engaged in both types of transactions, i.e., those transactions specified in Financial Code Section 17312(c) and those not specified, to maintain separate escrow or trust bank accounts for both types of business. The Commissioner proposes to amend Section 1732.2 to require an escrow agent engaged in both types of transactions to maintain separate books and separate escrow trust accounts for each type of escrow business in the same manner as provided in subsection (a). In addition, the Commissioner proposes to amend this section to require that escrow agents located outside the State of California, in addition to these requirements, to maintain separate books, records and escrow trust bank accounts for the escrow activity that occurs within the State of California as defined in Financial Code Section 17005.5.

Section 1737: Section 1737(a) provides that all money received by an escrow agent as part of an escrow transaction shall on or before the close of the next full working day deposit such money in the trust bank account. The Commissioner proposes to amend Section 1737(a) to include an exception for Internet escrow agents as provided under (proposed new) Section 1737.1.

Section 1737(b) makes a reference to the written instructions of the principals to the escrow transaction. The Commissioner proposes to amend this subsection to also include a reference to the electronic instructions received by an Internet escrow agent from the principals.

Section 1737(i) provides that no electronic fund transfers shall be made between "trust" or "escrow" account and any interest-bearing account. The Commissioner

proposes to amend this subsection to provide that an escrow agent may electronically transfer funds between the “trust” or “escrow” account and any interest-bearing account.

Section 1737(i) further provides that transfers between such accounts shall be made only in a manner consistent with the provisions of Section 1740.4 (which requires such transfers to be accomplished by the writing of a check). The Commissioner proposes to delete this provision of Section 1737(i).

Section 1737.1 (New): The Commissioner proposes to add Section 1737.1 to the regulations to address the use of credit cards and Automated Clearing House (“ACH”) deposits by Internet escrow agents and the losses that could result therefrom. The Commissioner proposes to adopt subsection (a) to provide that an Internet escrow agent shall deposit all money received from a credit card or ACH as part of an escrow transaction into a bank, a savings bank, or a savings and loan association in a separate account that is designated a “trust” or “escrow” account. Those funds received from a credit card or ACH shall not be deposited or otherwise commingled with any other escrow money. The Commissioner further proposes to adopt subsection (b) to provide that an Internet escrow agent shall not disburse any monies from an escrow where the deposits are received by credit card or ACH until the funds for that transaction have been deposited into the escrow trust bank account.

To address losses that could result from the acceptance of credit cards and ACH deposits, the Commissioner proposes to adopt subsection (c) to require that an Internet escrow agent establish a reserve for credit card and ACH losses in the amount of 10% of the average credit card and ACH receipts. The losses the reserve shall cover includes, but is not limited to, charge backs, disputed charges, fraudulent transactions and any other debits. If actual credit card and ACH losses exceed 10% of average monthly credit card and ACH receipts, the Internet escrow agent shall be required to immediately increase the reserve to equal the percentage of actual credit card and ACH losses to the average monthly credit card and ACH receipts. The Commissioner may approve a lower reserve if, in the opinion of the Commissioner, the lower reserves will be sufficient to cover anticipated credit card and ACH losses. The reserve will be in addition to the liquid asset and tangible net worth requirements of Financial Code Section 17210. In addition, the Commissioner proposes to adopt subsection (d) to provide that an Internet escrow agent shall be required to deposit funds from the reserve into the escrow trust bank account to cover any credit card and ACH losses on or before the close of the next full working day unless funds for that credit card or ACH deposit remain in the escrow account.

Section 1737.2: The Commissioner proposes to add Section 1737.2 to the regulations to address the use of Internet-authorized equivalent of money by Internet escrow agents. AB 333 amended Financial Code Section 17003 to allow Internet escrow agents who are engaged in the business of escrows involving personal property or services to accept the Internet-authorized equivalent of money for the purpose of effecting the sale or transfer of such personal property or services.

The Commissioner proposes to adopt subsection (a) to provide that an Internet escrow agent shall not disburse any monies from an escrow where the deposits are received from the Internet-authorized equivalent of money until the funds for that transaction have been deposited into the escrow trust bank account. The Commissioner further proposes to adopt subsection (b) to provide that an Internet escrow agent who wishes to transact business on a basis other than as provided by this section may request in writing a variance or waiver to the provisions in this section, but may not engage in business in a manner not in compliance with this section without first having received a waiver or variance in writing from the Commissioner.

Section 1737.1: The Commissioner proposes to renumber Section 1737.1 to 1737.3 and to amend this section. AB 333 amended Financial Code Section 17403.5 to provide that Internet escrow agents may maintain all records electronically and may provide those records to the Commissioner in electronic format. Existing Section 1737.1 sets forth the records to be preserved by escrow agents and allows the storage of such records by optical image storage media if certain conditions are met. The Commissioner proposes to amend this section to provide that an escrow agent may retain and provide these records in electronic format to the Commissioner provided the following conditions are met:

- (a) The electronic records are maintained and provided in a format that allows the Commissioner complete access to all of the books, accounts and records.
- (b) The electronic records must be provided to the Commissioner in a software format that is acceptable to the Commissioner and that the Commissioner has in his or her possession.
- (c) The escrow agent ensures that the Commissioner has the ability to download and print any or all of the records that are stored and maintained electronically.
- (d) The escrow agent shall provide any or all of the records maintained in electronic format in printed form if the electronic records are not in a format that is acceptable to the Commissioner or upon the request of the Commissioner.
- (e) The electronic records shall be maintained in a media that is (1) non-erasable "write once, read many" ("WORM") that does not allow changes to the stored document, (2) consistent with the minimum standards of quality approved by either the National Institute of Standards and Technology or the Association for Information and Image Management, and (3) contain written authentication identifying the electronic record as an exact unaltered copy of the document.

Finally, the reference to optical image storage media would be deleted and the proposed changes would apply to all escrow agents.

Section 1738: Section 1738 requires that all money deposited into an escrow trust account shall be withdrawn, paid out, or transferred to other accounts only in accordance

with the written instructions of the principals to the transaction or pursuant to a court of competent jurisdiction. The Commissioner proposes to amend this section to also provide that all money deposited into an Internet escrow transaction shall be withdrawn, paid out, or transferred to other accounts only in accordance with instructions that have been electronically transmitted and executed by the principals to the transaction.

The Commissioner also proposes to amend this section to provide additional requirements for escrow trust funds wired out of the escrow trust account. The escrow agent would need to comply with the following procedures for wire transfers:

- (a) The instructions authorizing the wire transfer must contain certain specified information.
- (b) The escrow agent must retain confirmation of the wire transfer from the financial institution that contains certain specified information.
- (c) If necessary, the escrow books should be properly adjusted to reflect the wire transfer.
- (d) The escrow agent must maintain a proper audit trail and adequate controls and safeguards for the wire transferred funds.

Section 1738.2: Section 1738.2 requires that an escrow agent shall use documents or other property deposited into escrow only in accordance with the written instructions of the principals to the transaction or pursuant to sound escrow practice or pursuant to a court of competent jurisdiction. The Commissioner proposes to amend this section to also provide that an escrow agent shall use documents or other property deposited into an Internet escrow transaction only in accordance with instructions that have been electronically transmitted and executed by the principals to the transaction.

Section 1738.3: Section 1738.3 requires that all written escrow instructions shall be dated. The Commissioner proposes to amend this section to require that, in addition to the written escrow instructions, all escrow instructions transmitted over the Internet shall be dated.

Section 1738.5: Section 1738.5 provides certain requirements for printed escrow instructions, including the requirement that in order for the instruction to be valid, it must be initialed by the principals to the transaction. The Commissioner proposes to amend this section by revising the heading from “Printed Instructions” to “Escrow Instructions” and by providing that instructions are also valid if they are electronically executed by the principals.

Section 1738.6: AB 583, AB 410 and AB 333 allowed Internet escrow agents to process certain types of escrows over the Internet, including the transmission and receipt of escrow instructions and other escrow documents electronically. The Commissioner proposes to add Section 1738.6 to provide that Internet escrow agents

may accept escrow instructions that are created, generated, sent, communicated, received or stored by electronic means provided that the principals agree to conduct the transaction electronically and acknowledge that they are able to electronically receive the escrow instructions, download and print the instructions. If a principal is not able to receive the instructions electronically, the escrow agent shall be required to mail a copy of the instructions within 24 hours of execution. This section would further provide that the principals may execute these escrow instructions with an “electronic signature” that complies with the federal Electronic Signatures in Global and National Commerce Act (the E-Sign Act).

Section 1740.1: Section 1740.1 requires an escrow agent that has a conflict of interest, such as also being a principal to the escrow transaction, to provide in writing a notice of interest to all parties to the escrow transaction. The Commissioner proposes to amend this section to provide that Internet escrow agents may provide the notice of interest electronically over the Internet to all parties to the transaction.

Section 1740.4: Section 1740.4 requires transfers between escrows to be accomplished by the actual writing of a check. The Commissioner proposes to add subsection (b) to Section 1740.4 to provide that this section does not apply to Internet escrow agents.

Section 1741.1: Section 1741.1 currently requires an escrow agent to issue consecutively prenumbered receipts for all escrow money deposited with or mailed to the escrow agent and retain copies of such receipts in a separate file. The Commissioner proposes to amend this section to allow an escrow agent to issue consecutively numbered receipts and that the copies shall clearly be identified as a copy.

In addition, the Commissioner proposes to amend this section to provide that an Internet escrow agent may deliver a copy of the receipt to the parties electronically over the Internet and may retain a copy of the receipt electronically in accordance with the provisions of subsection (b) of Section 1737.2. It would further provide that if a person is not able to electronically receive the receipt, the Internet escrow agent shall mail a copy of the receipt within 24 hours of execution.

Section 1741.3: Section 1741.3 requires every escrow agent to provide to each principal to the escrow transaction a statement of his or her account in writing. The Commissioner proposes to amend this section to allow an Internet escrow agent to transmit the statement of account to the principals to the Internet transaction electronically over the Internet and, in case a principal is unable to receive the statement electronically, to require the Internet escrow agent to mail a copy of the statement within 24 hours of its completion.

Finally, the Commissioner proposes to make several technical and non-substantive changes to some of the rules.

AUTHORITY

Sections 17203.1 and 17400, Financial Code.

REFERENCE

Sections 17003, 17004.5, 17005.1, 17005.3, 17005.5, 17200.8, 17203.1, 17207, 17209, 17209.1, 17312, 17403.2, 17403.3, 17403.5, 17404, 17405, 17409, 17409.1, 17410, 17411, 17415, 17420, 17421, 17601, and 17603, Financial Code.

AVAILABILITY OF MODIFIED TEXT

The text of any modified regulation, unless the modification is only non-substantial or solely grammatical in nature, will be made available to the public at least 15 days prior to the date the Department adopts the regulation. A request for a copy of any modified regulation should be addressed to the contact person designated below. The Commissioner will accept written comments on the modified regulations for 15 days after the date on which they are made available. The Commissioner may thereafter adopt, amend or repeal the foregoing proposal substantially as set forth above without further notice.

AVAILABILITY OF INITIAL STATEMENT OF REASONS, TEXT OF PROPOSED REGULATIONS/INTERNET ACCESS

The express terms of the proposed action may be obtained upon request from any office of the Department. Request Document OP 22/99-B. An initial statement of reasons for the proposed action containing all the information upon which the proposal is based is available from the contact person designated below. Request Document OP 22/99-C. These documents are also available at the Department's website www.corp.ca.gov. As required by the Administrative Procedure Act, the Office of Law and Legislation maintains the rulemaking file. The rulemaking file is available for public inspection at the Department of Corporations, Office of Law and Legislation, 1515 K Street, Suite 200, Sacramento, California 95814-4052.

AVAILABILITY OF THE FINAL STATEMENT OF REASONS

Upon its completion, the Final Statement of Reasons will be available and copies may be requested from the contact person named in this notice or may be accessed on the website listed above.

CONSIDERATION OF ALTERNATIVES

In accordance with Government Code Section 11346.5, subdivision (a)(13), the Department must determine that no reasonable alternative it considered or that has otherwise been identified and brought to the attention of the Department would be more effective in carrying out the purpose for which the action is proposed or would be as effective and less burdensome to affected private persons than the proposed action.

FISCAL IMPACT

- Cost or Savings to any State Agency: None.
- Cost or Savings to Local Agency or School District, or a Mandate Which Requires Reimbursement Pursuant to Part 7 (commencing with Section 17500) of Division 4

- of the Government Code: None.
- Direct or Indirect Costs or Savings in Federal Funding to the State: None.
- Other nondiscretionary cost or savings imposed on local agencies: None.

DETERMINATIONS

The Commissioner has made an initial determination that the proposed regulatory action:

- Does not have an effect on housing costs.
- Does not have a significant statewide adverse economic impact directly affecting business, including the ability of California businesses to compete with businesses in other states.
- Does not impose a mandate on any local agency or school district or a mandate that is required to be reimbursed pursuant to Part 7 (commencing with Section 17500) of Division 4 of the Government Code.
- Does not significantly affect (1) the creation or elimination of jobs within the State of California; (2) the creation of new businesses or the elimination of existing businesses within the State of California; and (3) the expansion of businesses currently doing business within the State of California.

COST IMPACTS ON REPRESENTATIVE PRIVATE PERSON OR BUSINESS

It is anticipated that this regulatory action may have a cost impact on individuals seeking to oversee a business location of an Internet escrow agent, whether as a manager or otherwise, in order to meet the proposed experience requirements set forth in this regulatory action so as to be deemed a “qualified person” for purposes of Financial Code Section 17200.8(b). However, it is anticipated that this cost impact will be minor to insignificant. Otherwise, the Department is not aware of any cost impacts that other representative persons or businesses would necessarily incur in reasonable compliance with the proposed action.

EFFECT ON SMALL BUSINESS

It has been determined that the adoption of these regulations may affect small business.

CONTACT PERSON

Nonsubstantive inquiries concerning this action, such as requests for copies of the text of the proposed regulations or questions regarding timelines, may be directed to Kathy Womack at (916) 322-3553. The backup contact person is Karen Fong at (916) 322-3553. Inquiries regarding the substance of the proposed regulation may be

directed to Timothy L. Le Bas, Assistant Commissioner & General Counsel, Office of Law and Legislation, Corporations Counsel, Department of Corporations, 1515 K Street, Suite 200, Sacramento, California 95814-4052. (916) 322-3553.

Dated: May 20, 2002
Sacramento, California

DEMETRIOS A. BOUTRIS
California Corporations Commissioner

By _____
TIMOTHY L. Le BAS
Assistant Commissioner and General Counsel
Office of Law and Legislation